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Veröffentlichungsversion / Published Version
Zeitschriftenartikel / journal article

Empfohlene Zitierung / Suggested Citation:

Kuznetsova, A. (2015). Towards a stable and dynamic economy in the Kaliningrad region. *Baltic Region*, 3, 83-95.
<https://doi.org/10.5922/2079-8555-2015-3-7>

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ECONOMY OF THE KALININGRAD REGION



TOWARDS A STABLE AND DYNAMIC ECONOMY IN THE KALININGRAD REGION

A. Kuznetsova^{*}



The economy of the Kaliningrad exclave is not sufficiently stable and is heavily affected by external factors. This work aims to estimate the current economic situation in the region and explore possible ways to increase the stability of regional economy. The study employs economic statistical methods and identifies factors affecting regional development. The author analyses the dependence of the manufacturing industry on customs and tax privileges under the law On the Special Economic Zone in the Kaliningrad region and federal programmes supporting the development of manufacturing and social infrastructure. The article stresses that the abolition of customs privileges in 2016 will result in a significant reduction in industrial output, since a lot of production is heavily dependent on imported raw materials and components. It is expected that the companies enjoying customs privileges to produce goods for the national market will receive government support for re-equipment. Effective use of the allocated funds would require setting up a regional programme identifying priority areas of regional economic development thus ensuring economic stability. There is also a need to support companies ensuring the economic — including food — security of the region.

Key words: Kaliningrad region, exclave, sustainable development, economy restructuring

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Submitted on February 20, 2015

doi: 10.5922/2079-8555-2015-3-7

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Introduction

There have been numerous attempts to implement concepts and strategies for the socioeconomic development of the Kaliningrad region [20; 23] devised by scholars and ex-

perts from Kaliningrad, Moscow, and various national and international research centres. Although none of these documents has been consistently implemented, some of their elements and provisions were used in the region in certain areas of public policy. In 2013-2014, a number of research projects were launched on a commission from the Ministry of Economy of the Kaliningrad region. These projects made it possible to perform an objective assessment of the regional economic situation and to identify promising areas of economic development. An inherent element of a regional development strategy is the policy for economic restructuring based on a more extensive use of local labour, natural, innovative, and other resources, as well as the sectoral approach and clustering [6; 12]. This article is a contribution to the discussion about promising ways to improve the sectoral structure of the economy, especially, in manufacturing.

Theoretically possible approaches to developing regional development strategies

Sustainable development of a regional economy is closely connected with the notion of regional competitiveness [10; 11; 24]. There are different methodological approaches to defining meso-level competitiveness. Russian and international authors distinguish between three basic approaches to defining regional competitiveness based on one of the three following aspects [17]:

a) economic aspect (capability to ensure an increase in gross value added and labour productivity and a high level of regional investment attractiveness, to support competitiveness of regional goods in the world and national markets, to encourage innovation, etc. In this case, regional competitiveness is considered as a derivative from the competitiveness of economic entities concentrated on the region's territory [24]);

b) social aspect (the capability to ensure relatively high standards and quality of living in the region, a consistently high rate of increase in actual wages and per capita income);

c) social and economic aspect (the capability to meet the needs of different actors — residents, economic entities, investors, etc. — and ensure an increase in the quality of living through a more effective use of the region's economic potential).

Some scholars also identify the environmental aspect of regional competitiveness as a link between the economic and social components [10; 17].

An assessment of a region's competitiveness includes identifying its actual and potential competitive advantages. Such analysis requires distinguishing between the notions of competitive advantages and competitiveness factors. The former are defined as a region's superiority in the quality and amount of potential and its ability to adapt to changes in its economic and social performance in comparison to competitors [14, p. 1398]. The competitiveness factor is a condition and/or cause of the presence/absence of certain competitive advantages.

In methodological and practical terms, the typology of competitive advantages proposed by G. Colletis and B. Pecqueur [28] is quite interesting. The typology was adapted to the Kaliningrad conditions by an international

research team led by I. Samson [7]. This approach suggests that all the resources determining the region's competitiveness can be divided in two groups (fig. 1):

a) by the pattern of utilisation: assets (utilised resources) and resources proper (i. e. hidden and currently unutilised resources);

b) by the presence and strength of connection between the value of assets/resources and the social, economic, cultural, environmental components of the region — general assets/resources, whose market value does not depend on a concrete project and specific assets/resources that are heavily dependent on the territory.

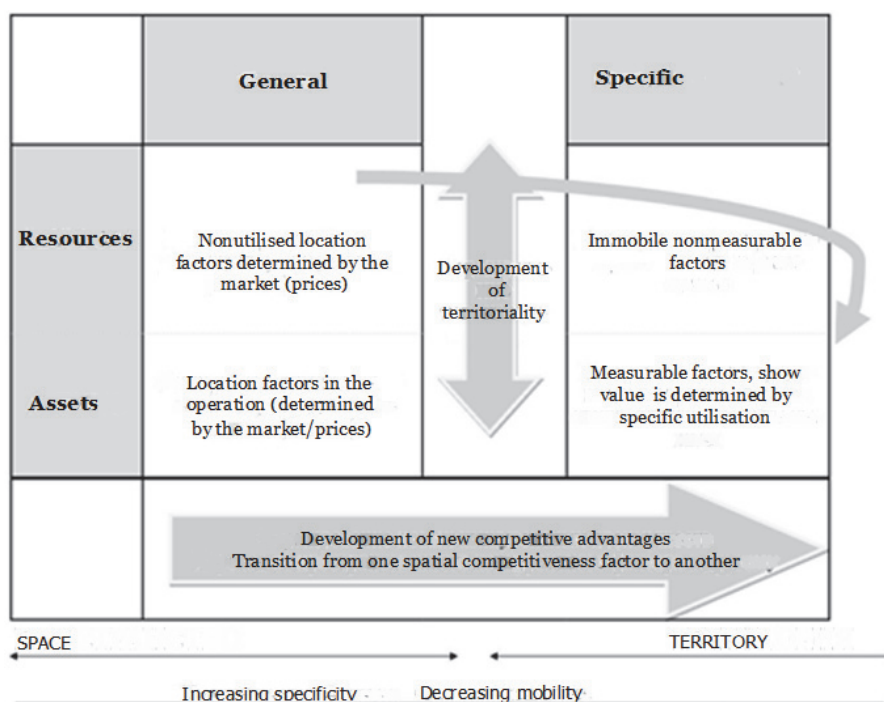


Fig. 1. Typology of regional competitive advantages

The formation of new competitive advantages requires a differentiated approach to the territory's development through systemic auditing efforts and strengthening their connection to assets. In a long-term perspective, such development strategy will make it possible to ensure the region's general competitiveness through preventing or minimising the processes of curtailing and transferring economic activities from the most significant areas of regional economy.

When devising a regional development strategy, it is important to take into account external and internal factors affecting the region's competitiveness. Depending on their nature, competitiveness factors can be both economic and non-economic (cognitive, social, cultural, institutional, etc.) [24]. Against the background of increasing globalisation and regions establishing

themselves as independent participants in international processes, the regions' significance is constantly growing. This trend is reflected in a number of studies into a wide range of issues relating to regional endogenous development (concepts of territorial capital, collective learning, territorial cohesion, territorial innovative models, etc.) [2; 26; 27; 29—31].

A major role in ensuring competitiveness of any region is performed by institutional factors, which can be endogenous and exogenous. If the change in factor value is a direct consequence of decisions and actions of economic policy agents at the regional level, this factor is endogenous. Otherwise, it is exogenous [24, p. 24]. The socioeconomic policy pursued by regional authorities in the framework of regional development strategy is an important endogenous institutional factor of competitiveness.

Geographical position of the Kaliningrad region is an important parameter determining the potential and areas of its development. There are two main factors — vicinity to the economically developed EU countries (and access to the sea) and remoteness from mainland Russia (exclavity). Assessing the correlation between these factors and the actual economic condition as of prognosis determines the content of regional development strategies. The actual choice of a strategy (made in collaboration with the regional and federal authorities) is affected by strategic attitudes and national socioeconomic development opportunities.

There are two approaches placing emphasis on the vicinity to the EU countries¹:

- stressing the need for integration into the (Western) European economic space (this variant was advocated in the 1990s, primarily by Western authors);

- considering the region as a 'bridge' (a 'pilot region', 'cooperation region' or 'development corridor'; this variant is supported by the majority of Kaliningrad scholars).

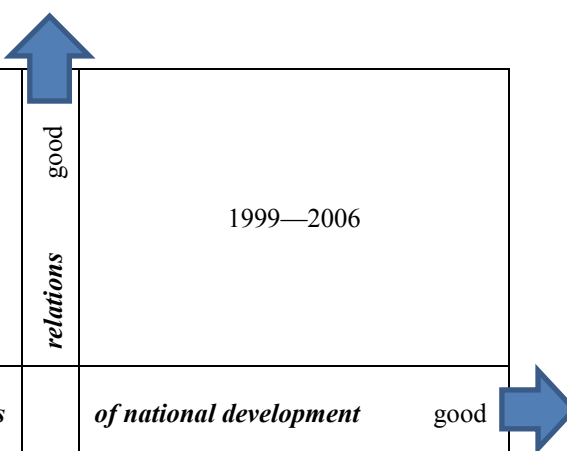
The other two approaches focus on the problem of exclavity and the ways to solve it:

- economic development through using regional resources (natural, human, etc.), attaining economic security, and increasing region's self-sufficiency (developed by some Kaliningrad authors);

- assumption about the inevitable increase in Russia-EU integration processes, which would facilitate solving the exclavity problems (cautious statements by some authors voiced during the term of Partnership and Cooperation Agreement between Russia and the EU, 1997-2007).

The most promising avenue is using and harmonising all the above approaches in view of the features of national socioeconomic development and the particularities of Russia-EU relations. The correlation between these parameters forms the matrix of regional development conditions (fig. 2).

¹ For a detailed analysis of approaches and strategies, see [19].



1992—1998	good	1999—2006
bad	<i>relations</i>	good
2014—2015.	Russia — EU	2007—2013.
	bad	

Fig. 2. Matrix of general conditions of the Kaliningrad region's development

As figure 2 shows, the period that started in 2014 is characterised by the least favourable conditions for regional development — both at the national (plummeting oil prices) and international levels (bilateral Russia-EU sanctions). (Russia's reciprocal sanctions banning food imports from the EU strongly affected regional import substitution companies focusing on processing imported agricultural raw materials). Therefore, there is a need to restructure the economy and make it less sensitive to external shocks.

The region has developed an economy strongly dependent on privileges granted under the Law on the Special Economic Zone in the Kaliningrad region [15; 16] and investment in infrastructure made within the Federal Targeted Programme for the Development of the Kaliningrad Region until 2020 [22]. In other words, its basis is shaped not by regional factors, which could ensure the economy's stability to external shocks, but rather by artificial institutions factors, without which many regional companies become unviable. The shortcomings of the SEZ mechanism, which contributed to the development of an unstable rent-based economy, were identified using an analysis of regional model of commodity flows in the early 2000s [4; 5]; the results obtained were corroborate by recent research [3; 6; 12].

Assessment of manufacturing production specialisations

Each constituent entity of the Russian Federation strives to attain economic development objectives pursuing both regional and national interests.



The latter consists in either producing goods and services for other constituent entities or producing them for export. The economy of the Kaliningrad region is integrated into the world market to a greater degree than those of many other Russian regions. Firstly, this is a result of the region's participation in supporting Russian foreign economic connections. Secondly (but equally importantly), most of regional processing facilities use imported raw materials and semi-finished goods. Thirdly (less importantly), it produces goods and services (the field of tourism) for export. Fourthly, the region is home to a significant number of joint and international companies (foreign investment per capita is below the national average if Moscow is taken into account and is above it if Moscow is excluded from comparison). Firstly, the vicinity of state borders turns almost all economic transactions into foreign economic ones, whereas transporting raw materials and finished goods depends on the border regime and interactions between the neighbouring states.

The Kaliningrad region is a territory producing a number of goods and services for the national and, to a smaller degree, international market (table 1).

Table 1

Goods and services produced the Kaliningrad region for regional, national, and global markets as of 2014, by economic activity

Economic activities	Target market		
	regional	national	global
<i>Production of commodities</i>			
Agriculture, hunting, and forestry	++ ²	—	++
Fishing and fish farming	++	+	+
Mineral extraction	++	—	++
Processing	+	++	+
Power, gas, and water generation and distribution	++	—	—
Construction	++	—	—
<i>Production of market services</i>			
Wholesale and retail; automobile and motorcycle repair; housekeeping maintenance	++	—	—
Hospitality and restaurants	++	+	+
Transport and communications	++	++	+
Finances	++	—	—
Real estate services	++	—	—
<i>Production of non-market services</i>			
Public administration, defence, welfare	++	++	—
Education	++	+	—
Healthcare and social services	++	—	—
Other utility and personal services	++	—	—
Housekeeping services	++	—	—
Activities of extraterritorial organisations	—	++	+

Market significance: ++ high, + medium, — low.

² Including that to meet the needs of the local food industry.

Production of commodities is often targeted at the national and even global rather than the regional market.

Agricultural produce — depending on its type — is supplied to the regional and global markets. The regional market accounts for most of livestock produce (except for furs that are exported). As to horticulture, fodder crops, potatoes and vegetables, and a small proportion of grain are consumed locally (not only by population, but also by processing industries). Most grain and rapeseed is exported.

Most fishery products are processed in the region, but partially are transported unprocessed to the other Russian regions and abroad.

Most amber (as a semi-finished good), peat, and oil are exported. Construction minerals (sand, clay, gravel, and sand-gravels), mineral waters, and therapeutic muds are used in the region.

The produce of Kaliningrad manufacturing companies (especially, motor and shipbuilding industries, electronic appliances production, and furniture manufacturing) is targeted primarily at the national market. Certain machines and equipment, the produce of oilseed, wood processing, pulp and paper, and chemical industries, as well as ferrous metals are exported. Vessels — including military ones — are often built for export. To a degree, all companies work for the regional market, however, it is the primary target for the food, wood processing, printing, furniture, and construction material industries (table 2).

Table 2

**Produce of Kaliningrad companies targeted at the regional,
national, and global markets, 2014**

Processing industries	Target market		
	regional	national	global
production of food, including beverages and tobacco	++	++	+
textile and clothing manufacture	++	+	—
leather, leather goods, and shoe manufacture	++	+	—
timber processing and wood ware manufacture	++	+	++
pulp and paper and printing industries	++	—	+
coke and petroleum product industries	++	—	—
chemical industry	+	+	++
rubber and plastic product manufacture	+	+	++
manufacture of other non-metal mineral products	++	—	—
metallurgy and metal product manufacture	+	—	++
machine and equipment production	+	+	++
production electric appliances, electronic and optical equipment	+	++	—
production of vehicles and equipment	+	++	+
other industries (including furniture)	++	++	+

Market significance: ++ high, + medium, — low

Construction and all types of economic activities producing market and non-market services (except for the activities of extraterritorial organisations) are targeted at the regional market (either completely or to a significant degree). Transport, public administration, and national security are of not only regional, but also national significance. Hotels and restaurants providing services for tourists work for both the regional (accounting for a considerable proportion of restaurants' sales) and national/world markets.

A serious problem of many Kaliningrad manufacturing companies lies in their strong dependence on the customs privileges under the 1996 SEZ law. Table 3 shows the contribution of firms working under different economic regimes to the overall performance of manufacturing companies.

Table 3

**Contribution of firms working under different economic regimes
to the overall performance, 2013, %**

Regime	Parameter		
	Employment	Fixed asset value	Output
SEZ 1996	38.8	16.9	71.7
SEZ 2006	17.7	48.2	12.2
SEZ 1996 и SEZ 2006	6.1	23.5	6.4
Other	37.4	11.4	9.7
<i>Total</i>	<i>100</i>	<i>100</i>	<i>100</i>

Companies working under the 1996 SEZ regime (including those combining both regimes) account for 45% of all employees of manufacturing firms, 40% of fixed asset value, and 78% of output. However, the proportion of produce of local manufacture is much lower due to the low level of value added. It is worth stressing the positive role of tax exemptions under 2006 SEZ law. SEZ residents enjoying tax and customs privileges account for 72% of the fixed asset value in manufacturing.

Improving the regional development strategy

The state programme for the region is aimed at 'creating conditions for the sustainable socioeconomic development of the Kaliningrad region to attain standards of living comparable to those in the neighbouring countries, as well as developing a favourable investment climate in the region to facilitate cooperation between Russia and the EU member states' [19]. This suggests that significant federal financing is allocated for developing the region's industrial and social infrastructure and improving the environmental conditions. Financial resources are allocated in the framework of the federal targeted programme for the development of the Kaliningrad region until 2020 [22].

State programmes for the Kaliningrad region have been developed in line with the above documents. The 'Economic Modernisation' programme presents a socioeconomic forecast based on the following factors:

— an assessment of the actual parameters of the national and regional economic development;

— the 2016 changes to the regional economic regime (provisions of the law on the special economic zone in the Kaliningrad region [15; 16]);

— federal documents developed prior to 2103 envisioning the development of all Russian regions — the Long-term Forecast for Socioeconomic Development of the Russian Federation until 2030 [18] and the Long-term Concept for Economic Development of the Russian Federation until 2020 [8];

— opportunities granted by the state programme for socioeconomic development of the Kaliningrad region until 2020 and the federal target programme ‘Development of the Kaliningrad Region until 2020’.

The ‘Economic Modernisation’ programme pays special attention to a certain condition of the Kaliningrad region’s development, which seemed most relevant as of the document preparation (it is still relevant today). This condition is the 2016 abolition of the customs privileges granted under the SEZ regime (it was stressed that the continuation of the regime would not be possible following Russia’s accession to WTO and the regulations of the Customs Union and the Single Economic Space regulations coming into force).

The programme identifies manufacturing and other industries (wholesaling, transport) sensitive to the repercussions of the 2016 problem. Moreover, it is shown that the 2009 global crisis strongly affected companies working for the national market using customs privileges. Throughout growth periods in the national economy, the Kaliningrad region shows above the average growth rates, during crises it takes a more dramatic downturn [6; 12]. It is important to take into account negative forecasts for 2015 and following years produced by numerous experts.

The ‘Economic Modernisation’ programme stresses that regional development is impossible without serious restructuring of the economy and introduction of new methods to stimulate and support priority industries. Indeed, during the 2014 visit of the Chair of the Government of the Russian Federation to Kaliningrad, it was declared that 1996 SEZ residents affected by the abolition of customs privileges would receive financial support to modernise production and adapt to new conditions. The compensation procedure is being developed. However, its key criterion will be the availability of a business plan capable of ensuring an economic entity’s effective performance. Tax exemptions for investors granted under the 2006 SEZ law will serve as an additional boost to the development of a new sectoral structure.

Today, it is difficult to forecast short-term changes in the regional economic development. All experts interviewed in a survey conducted in the region in autumn 2014 expect several years of decline in industrial production and overall deterioration of the regional economic situation [1]. Overcoming the crisis requires restructuring the economy, especially, the manufacturing, agricultural, and fishing industries.

Studies carried out in 2013-2014 on a commission from the Ministry of Economic Development of the Kaliningrad region produced important findings relating to the assessment of factors, features, and priorities of regional development [1; 6; 12; 21].

In view of the geopolitical changes of the second half of 2014, the earlier adopted federal and regional documents can be supplemented with the following provisions:

1) there is a need to focus on ensuring the region's economic security, especially, food security. The region's agricultural industry has a good potential for development. Diversification of power supply, ensured by the construction of the Baltic NPP (if the issue of power exports is solved) and small heat power plants burning natural gas and black coal, will contribute to economic security. There is a need to increase the capacities of underground gas storage facilities.

2) there is a need to increase the proportion of manufacturing companies using local raw materials (through developing industries using agricultural raw materials and local minerals);

3) economic restructuring requires paying special attention to developing cooperation between regional companies and establishing cross-industry clusters. Better spatial organisation of production means increased efficiency.

However, modern geoeconomic concepts advise against focusing solely on the regional or even national market. There is a need to secure an advantageous position in global production chains, preferably, at hi-tech stages of goods and services production. Theoretical provisions suggest that assembling (prevalent in the Kaliningrad region) is far from the lowest stage of production and commodity distribution. Unfortunately, in 2016, this favourable position will be lost for regional companies. There is a need to look for new, preferably cost effective, ways to use the labour of specialists who will lose their jobs at import substitution companies — today's basis of the region's manufacturing potential.

In a market economy, neither federal nor regional authorities are directly involved in the management of goods and services production. They create infrastructure prerequisites for attracting investors. However, in critical cases (the need to support the Russian Baltic exclave), it is possible to provide funds for technological re-equipment of production. The federal funds allocated for economic restructuring can be managed within a special programme identifying industrial, cross-industry, and institutional priorities, the latter ensuring development of industrial connections between companies.

Conclusions

Today, the Kaliningrad region's economy is unstable and sensitive to external effects (the situation in the global and Russian market, the rouble exchange rate, Russia-EU relations) and federal support for socioeconomic development (SEZ laws and federal programmes). However, the potential of the regional natural, human, and innovative resources has not been fully developed. It is possible to use additional financial resources that can be allocated in the framework of a social programme to support companies affected by the 2016 abolition of customs privileges. The programme should include the following priorities:

- a more extensive and effective use of land resources (development of an agri-food industry using local agricultural raw materials and fish);
- using the environmental conditions and therapeutic resources (muds, mineral waters) to develop medical, water sports, and ecotourism;
- introducing new mineral resources into economic uses, creating an amber cluster, extracting associated minerals (phosphate rocks, glauconites, construction materials), encouraging the manufacture of jewellery, perfumes, and amber-based chemical products and industrial components;
- more innovative production, development of research and business partnerships;
- aligning professional training with the current and perspective needs of the economy;
- encouraging cooperation between companies, development of cross-industry clusters bringing together large, medium, small, and microenterprises; this will contribute to the formation of value added production chains and an increase in value added in the region.

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